The Import-Substitution Strategy of Economic Development

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There are many ways of looking at the manner in which economic development is taking place in the hundred or more countries which today are still to be classified as “underdeveloped.” The most frequently discussed categorization is probably that between the “capitalist” and “socialist” modes. The United States, in spite of its own very mixed economy, stands forth as the great protagonist of the capitalist or “free-enterprise” method of development, while countries under control of Communist parties, as well as many which are not, profess to favor the socialist strategy of development.

However, this distinction does not answer many of the questions which are raised by the process of economic development. Both free enterprise and socialism are subject to many varying interpretations, and once a country has formally chosen one or the other, this decision leaves many issues unresolved.

In the present article, we wish to present another view of alternative development strategies and to discuss one of these at length. Not all of this discussion will be new, but we hope that it will answer some questions with regard to the behavior of groups involved in the process, particularly the entrepreneurs—behavior which is difficult to explain in other terms.

ALTERNATIVE DEVELOPMENT STRATEGIES

One may look at the process of economic development as involving one or another of at least four strategies: the manufacture-export, the forced-capitalization, the primary-product-export, and the import-substitution strategies.[1]

The major historical example of the manufacture-export approach has been Great Britain. As the first of the world's great manufacturing nations, it was able from the inception of its industrialization process to finance much of its capital accumulation by export of textiles, metal products and other industrial commodities to Europe, the Americas and other parts of the world.

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This is a difficult approach for any country to follow today. Few newly industrializing nations are in a position from the inception of manufacturing to export their products on a large scale. Perhaps Puerto Rico fits into this category because of its peculiar constitutional arrangements with the United States, which made possible from the beginning its access to a very large market as well as low-cost capital funds and expert managerial resources in sizeable quantities.

The second model is that of the Soviet Union and other Communist-controlled countries which have followed its lead for a longer or shorter period of time. Their strategy of all-out capital accumulation was made possible by exceedingly intricate and detailed planning—and a tyrannical dictatorship which was able, for a generation, to suppress all protests from segments of the community that suffered from the process. Not even many of the Communist countries are loyal to this formula any longer.

The third strategy of development is that which the Russians seem to have imposed during the last three years on the Cuban government of Fidel Castro. After several years of following the Soviet model, the Castro government in

1964 switched to a program of all-out emphasis on stimulating sugar production for export, with the aim of turning out ten million tons a year by 1970. Fidel boasted then and later that with this greatly augmented output of the country's traditional major export crop, Cuba would be able to purchase abroad all of the capital equipment it would need for its industrialization. This model has been recommended by the Soviet Union to various African countries.

The fourth method of development is that of import substitution. Those countries following this strategy—including the majority of today's underdeveloped nations, whatever their ostensible ideology—industrialize through the process of building up manufacturing enterprises to produce goods which were formerly imported. They commence with the establishment of industries producing light consumer goods, such as textiles, processed foodstuffs and light metallurgical products, and then move on in many cases to iron and steel, heavy chemicals and other complicated and capital-intensive products. It is this strategy of economic development to which we want to devote the rest of this article.

1. The phrase 'import substitution' as a description of the process by which many countries are industrializing is an old one, going back at least a couple of decades. The only claim for originality in the present paper is that, hopefully, it presents some of the implications of this method of development which have been but little explained heretofore.

BACKGROUND OF IMPORT-SUBSTITUTION PROCESS

The countries which follow the import-substitution strategy generally passed first through a phase in which a sector which was modern and was attached to the world economy was developed alongside but separate from a traditional, largely self-sufficient economy. This process began during the last part of the nineteenth century in most Latin American countries—and in many Asian and African ones—and continued, more or less, until the World Depression of 1929. It was stimulated or brought about by the fact that the early industrial countries of Western and Central Europe and of Northern America did not possess within their borders sufficient sources of key raw materials and foodstuffs. They did not have tropical agricultural products; they did not possess sufficient quantities of minerals such as nitrates, copper, zinc, lead, tin and, later, petroleum.

In order to obtain these, the early industrial nations invested large sums in the countries of Latin America, Africa and Asia, which had traditional economies and societies of one kind or another—from those of the Stone Age to the ancient civilizations of India and China. Their investments opened up modern mines and modern plantations. They developed the transportation systems—principally railroads—necessary to get goods to the ports from which they were shipped to Europe or North America. They also built the ports to handle these goods; they likewise provided modern banking systems and commercial enterprises necessary to handle the goods being shipped to the already industrialized nations, as well as handling those commodities brought back in payment.

The net result of all this was the development, alongside the traditional economy and society, of a sector which was modern, both sociologically and economically. This sector was closely tied to the world market, its prosperity depending entirely on whether the one or two major export products of the country could be sold at good prices and in ample quantities. The economy of the modern sector, therefore, became very unstable and highly subject to influences from abroad.

At the same time, this process brought into existence new economic and social classes. It developed a new middle class, tied to the commerce of the modern sector; and it also involved large numbers of white-collar workers in private employment and in the government services which greatly expanded in consequence of the development of the modern sector. Likewise, a new manual working class developed to man the modern mines, the modern plantations, the railroads, the ports, and the incipient new industries which began to emerge as the result of the considerable expansion of the domestic market.

These new social and economic groups were discontented with the status quo ante. They were unhappy at the continued control of the society, the economy and politics by the traditional ruling elite—be it native landowners or tribal chiefs, or composed of colonial administrators. However, particularly in countries such as those of Latin America where political colonialism did not exist, these new groups were not powerful enough to challenge effectively the ancien régime until the countries had moved substantially into the next phase of development.

The second stage of economic development, in conformity with the import-substitution process, arose as a result of interference with the export-import pattern established earlier. The first such shock came during World War I, when it became exceedingly difficult for the economically dependent, or "colonial," countries to obtain the manufactured goods they were by then accustomed to receiving from Europe and the United States. As a result, the people of these nations either had to do without these goods or produce them domestically. In many of the underdeveloped countries, consequently, the process of industrialization really received its first great impetus during World War I.

Once World War I was over, many of these early industries could not meet the competition coming from European and North American manufacturers. However, soon after the war came the Great Depression, during which the same phenomenon occurred as had taken place a decade earlier, only in an exaggerated form. It was the depression which convinced public opinion in the underdeveloped countries which were politically independent that there was need for a conscious policy of industrialization and general economic development.

World War II, following hard on the heels of the depression, confirmed this belief. As former colonies achieved their independence in the postwar period, their leaders were imbued with the same conviction of the need for rapid economic development and, most important of all, for industrialization. Hence, since the Great Depression and particularly since the war, the

governments of the underdeveloped nations have been following policies, such as protectionism, the building of social capital and even the financing of new manufacturing industries, which make the import-substitution mode of development possible.

MARKET SITUATION IN IMPORT-SUBSTITUTION INDUSTRIALIZATION

The most significant single fact about the import-substitution strategy of development, which most underdeveloped countries adopted, consciously or unconsciously, is that as a result of it the size of the market is not a problem of major significance in the first phase of industrialization. A new industry, built to turn out a product which has formerly been imported, possesses from its inception an assured market of predictable size. One set of statistics which even most underdeveloped countries possess is that concerning imports and exports, since most government revenues come, in the early phases of development, from taxes on the country's foreign trade. Hence, it is relatively simple to ascertain the quantity of a given product which has been imported —and therefore the national market for that product which is available when an import-substitution industry is established.

Furthermore, the import-substitution process tends to expand the market more or less automatically, at least for a while. The workers recruited into these new industries from the non-market sectors of the economy, or from employment in which their productivity and income were much smaller than they are in industry, receive a money income on which they principally depend to obtain the goods and services they need, and so serve to expand the market for consumer goods. In addition, the development of consumer industries tends to create a market for some capital goods. Thus, the existence of a sizeable textile industry, for instance, gives rise to a market for textile machinery, or at least replacement parts. In turn, the existence of a textile-machine industry, certain kinds of metallurgical fabricating enterprises, and so forth, may provide the market after a while for a steel industry.

As a result of these circumstances, the entrepreneurs are faced with the happy situation in which, for a time at least, they do not have to be very much preoccupied with the problem of expanding the market for their goods.

Their problem is one of meeting the demand which is open to them rather than of generating new markets.

EFFECTS OF MARKET SITUATION

The fact that new industries being established under the import-substitution scheme of development do not have to be preoccupied with trying to augment the number of their customers serves to explain, and make rational, many phenomena which are otherwise difficult to understand in the early phases of industrialization. It helps to explain the relatively little attention paid to such matters as the training of management, the formal training of a labor force, costs of production, quality control and advertising. It also goes far to explain the attitude which leaders of many of the newly industrializing nations have toward the agricultural sector of their economies, and the attitudes which the industrialist class has toward rural problems.

There is relatively little need in the early phases of import-substitution industrialization to pay great attention to the development of a highly trained managerial force. Most native industries tend to grow from artisans' workshops or from commercial enterprises which begin to produce some of the things they sell. These entrepreneurs are self-made men who have learned to run an industry by running it and whose methods may be quite unscientific, though sufficiently expert for the needs of the early period of industrialization. The higher costs of production growing out of inefficient management are no great problem because they can easily be passed on to the consumer, who is forced in any case to buy nationally made goods.

Similarly, the problem of developing a highly efficient manual labor force does not have the urgency that, a priori, one might expect it to have, and for much the same reason. An inefficient worker, learning his skills "on the line" by working alongside an older self-taught employee, undoubtedly makes for relatively high costs of production. But these costs, too, can be passed on more or less easily to the purchaser of the product.

Quality control can also well be overlooked in the first phase of import-substitution industrialization. Even though in the abstract the consumer might prefer to buy a foreign-made good the quality of which he could depend upon, he has in fact no such choice. With time, perhaps he even gets used to the varying nature of the products he purchases.

Furthermore, during this phase, there is relatively little need for advertising.

Anyone who has spoken with members of advertising firms in the underdeveloped countries will be aware of the difficulty they have in selling local entrepreneurs on the need for advertising and of the fact that most advertising volume comes from foreign firms. This sales-resistance is rational, given the circumstances. Again, the readily available markets make heavy advertising unnecessary. Firms which are affiliates of foreign enterprises, particularly American ones, may engage in advertising, but they perhaps do it more as a reflection of the experiences of their parent companies than as a function of real need in the developing country.

This situation of lack of concern over the consumer's reactions, in terms of price and quality, is augmented by two other factors which are often, if not usually, present in the developing countries. One of these is the existence of inflation, a generally rising price level, which makes less conspicuous—and hence less damaging to the individual industrialist—the increase in the price of a particular manufactured item. The second is the fact that competition is relatively limited during this phase, there being only a small number of producers who are more engaged in absorbing the purchasing power which is readily available than they are in trying to take markets away from the few competitors who may exist.

THE SITUATION OF AGRICULTURE

The market circumstances surrounding import-substitution industrialization go far to explain the situation of agriculture during the early phases of the process. It has been widely noted that there is a tendency in the new, industrializing countries more or less to ignore agriculture. It has also been noted that the industrialists tend to be little concerned with the need for agrarian reform, which (other things being equal) appears to be necessary for the continued rapid development of industry itself. Both of these phenomena make sense in the early phases of the development of a country which is using the import-substitution process for expansion of its manufacturing and tertiary sectors.

That part of the agricultural sector which has not become involved in producing for export generally remains very backward, technologically and socially, in the underdeveloped countries. In most of these nations (with the possible exception of Black Africa) there exists a system of large landholdings, in which the land is tilled by workers employed under some form of sharecropping or tenant farming or else are engaged at exceedingly low wages. Those who work the land are essentially subsistence farmers with little or no money income. The money income that is generated in this segment of agriculture goes mainly to absentee landlords, living in the urban areas or abroad.

However, there is little pressure to do anything about these conditions of agriculture during the early phases of import-substitution industrialization. In the first place, in almost all underdeveloped countries there is a good deal of hidden unemployment or surplus employment in agriculture. It is thus possible to recruit the new industrial labor force from those who are marginally employed in the rural sector. At the same time, their migration into urban areas does not decrease the output of agriculture; it perhaps even results in some increase in productivity and output in the rural part of the economy. In many instances, too, there is some spillover into agriculture from the introduction of new techniques and new capital in the manufacturing sector, which at least for a while may be enough to bring about some increase in agricultural output.

It is true, of course, that the rapid increase in the urban population which

accompanies industrialization has a tendency to increase the demand for footstuffs, while the growth of manufacturing results more or less automatically in an increase of demand for agriculturally produced raw materials. However, for some considerable period of time, this increased demand for foodstuffs and raw materials can be met by imports. The development of domestic industries producing goods which were formerly brought in from outside makes available the foreign exchange which was formerly spent on these manufactured goods and which can now be used to pay for food and raw-material imports.

Thus it is not surprising that in the process of import-substitution industrialization there is a tendency to ignore agriculture. Not only is relatively little attention given to raising agricultural output by investment in the rural sector, but little is done to bring about changes in the landholding pattern which might bring a larger portion of the agricultural population into the market.

The fact that the expansion of the available market is not a major problem for new manufacturing enterprises, together with the fact that the foreign exchange which was formerly used to pay for industrial products is now available to bring in food and raw materials, means that in this phase of development there is little pressure from the urban sector for changes in agriculture. The manufacturers and other groups in the cities are loathe to see any appreciable amount of the country's scarce capital resources invested in agriculture, at the expense of industry and its needs. At the same time, the industrialist sees little immediate need for an agrarian reform, which might actually bring large proportions of the rural sharecroppers and tenants into the market for manufactured goods for the first time. At this point, the manufacturer is likely to be more concerned with the general dangers to private property—including his own—which are raised by any suggestion to redistribute large landholdings than he is with any long-run advantages which might accrue to him from converting new small landholders into customers for his products.

In any case, even if industrialists as a group were to favor agrarian reform, it is doubtful that they would have sufficient political influence in most cases to bring about such a change. There is a tendency for the traditional landlords to retain political influence out of all proportion to their numbers and economic power throughout most of the import-substitution process.

Nor is there much demand in the rural sector itself for either technological or land-tenure change. There is no great demand from either the conservative small peasant or from the very conservative large landowner for the introduction of new methods and hence the investment of sizeable amounts

of capital in agriculture. The peasant is satisfied to do things as his ancestors have always done them; in fact, he may not yet have the needs which give him incentive to produce more, even if he becomes convinced that he can do so. The large landowner is satisfied with the living which his present methods give him; he is likely to be engaged in conspicuous consumption and to be spending all or virtually all of his current income. He therefore sees little need to take part of what he is spending on consumption and invest it in new methods and machinery. All the less is he inclined to do so when he still has available large quantities of very cheap labor, which would only be made superfluous by his adopting a more capital-intensive method of production. In fact, an appreciable part of his real income and much of his social prestige arise from the sizeable number of personal retainers he is able to maintain under the traditional conditions of agricultural production.

There is not even likely to be much pressure from the tenant farmers or sharecroppers for agrarian reform in the early phases of import-substitution industrialization. The more aggressive members of this class are likely to be siphoned off to the cities to work in the new industries or in tertiary activities. For a long time those who remain behind will not have any feeling that social mobility within the rural structure is a possibility for them; and until they do become convinced that it is possible, they are not likely to demand a change in conditions which seem to have existed virtually forever and to have been determined by the gods.

This lack of significant pressure from either the urban sector or from within agriculture itself for changes in the rural part of the economy during the early phases of import substitution helps to explain one phenomenon which has worried many economists of the already industrialized countries. In spite of the constantly reiterated advice of these foreign experts, the industrializing countries for the most part have stubbornly resisted the suggestion that they need “balanced development,” that is, that the growth and diversification of agriculture should accompany the development of industry. Within the conditions of import-substitution industrialization, there is for a long period of time no particular incentive, as we have indicated, for government authorities or anyone else to put major emphasis on agricultural development. During this phase, it is quite rational for the public authorities and also the private investors to concentrate their efforts on manufacturing and the services needed to facilitate it, such as electric power and certain transportation facilities. It would involve a misallocation of resources for sizeable quantities to be diverted in this period to the development of the rural economy.

THE CRISIS OF THE IMPORT-SUBSTITUTION STRATEGY

Sooner or later the import-substitution strategy of development reaches a point of exhaustion. A point is reached at which an economy has installed virtually all those kinds of industries which can produce commodities formerly imported. At this juncture, the nature of the development problem changes. Instead of being the largely physical one of mounting industries to produce goods for which there is already a market, it becomes one of amplifying existing markets—if the process of development and growth is to continue.

This shift in the nature of the economic-development problem has implications both for the individual enterprise and for the industrial sector as a whole. The individual firm is likely to be faced with a great deal more competition than was previously the case. There will then be only two ways for a firm to expand its sales: either by taking customers away from rival enterprises or by developing customers among those who have not been in the market for its goods at all. If a firm's management, unaccustomed to real competition in the early phases of industrialization, is inclined to continue in its old ways and habits developed in the period when an adequate market could safely be taken for granted, it is likely to run into serious trouble. A more aggressive competitor is apt to begin to take away customers. Furthermore, once the supply of a given industrial product has caught up with the existing demand, the customers are likely to become more selective than was formerly the case.

All of this means that many things which could previously be overlooked now become matters requiring the urgent attention of the management of individual industrial enterprises. One way to increase the market for specific products in a competitive situation is to reduce their prices; thus, entrepreneurs will find themselves forced to become interested in and concerned with the problem of reducing costs and rationalizing their operations. Another method of increasing the individual firm's market will be to assure the customers of a higher degree of uniformity of quality than was formerly the case, and so quality control will assume an importance it did not

have in the early phases of import-substitution development. Because of these changes in market conditions, firms will be forced to pay more attention to the quality and performance of their management personnel. They will find new incentive to try to develop a better trained and more efficient labor force.

From the point of view of the industrial sector as a whole, new conditions will now demand a new outlook and new policies. With the virtual completion of the import-substitution phase of industrialization, it will be to the advantage of the manufacturing firms as a group to bring about an increase in the purchasing power of large segments of consumers who have been in the market but whose incomes have been so low as to permit them to buy only relatively small amounts of goods, and to bring into the market those parts of the population which have hitherto been outside of it.

The first problem will involve particularly the urban wage earners who constitute a substantial proportion of the market for consumer goods. Although their real-income levels have been substantially higher in the import-substitution phase than the incomes of most rural workers, they have generally remained well below comparative wages in the older industrialized countries. An increase in their real wages can constitute an important increase in existing markets. The increase in the real purchasing power of this group will require both an increase in their productivity and a rise in their share of the returns from what they produce. The laborers' need for greater productivity makes the increased concern for costs and quality, which we noted as being to the advantage of each individual firm, to the advantage also of the industrial sector as a whole. The laborers' need for a larger share of their product will require a change in the psychology of the industrial entrepreneur, who has tended in the import-substitution phase of development to stick rather too closely to the habit of the traditional merchant of turning out relatively small amounts of product at a large markup per unit. The psychology of mass production will contribute considerably to the possibility of mass consumption.

The need for bringing into the market those elements which heretofore have been largely out of it will require fundamental changes in agriculture. An agrarian reform now becomes of great importance, both as a means of bringing new consumers into the market—the large numbers of rural workers, sharecroppers, tenant farmers who have not been in the market—and of laying a basis for an increase in domestic agricultural output, thus making it possible for agriculture to produce more adequately the raw materials and foodstuffs required by the urban sector.

In addition, it becomes important at this point to have heavy investment in

agriculture, in terms both of providing equipment and machinery, and of developing more adequate marketing and storage facilities and providing fertilizers, credit, extension services, experimental stations and the like. Large investments will also be required to develop adequate transportation facilities, not only in terms of major highways and perhaps occasional railroads, but also neighborhood roads permitting the agriculturalists to get their products to the main transportation arteries.

APPLICABILITY OF IMPORT-SUBSTITUTION MODEL

So far, few of the underdeveloped countries have reached the third phase in the import-substitution strategy of economic development. Virtually all of the developing countries in Asia and Africa, as well as most of those in Latin America, would seem to be still at a stage in which their industrialization is proceeding on the basis of building industries which can produce import substitutes. However, there are a few Latin American countries—notably Brazil, Chile, Mexico and Argentina, as well perhaps as Venezuela, Colombia and Peru—which have completely or nearly exhausted import-substitution possibilities, at least as a major impetus to further development.

The problems faced by these Latin American nations which have reached the end of import substitution indicate that the transition to the post-import-substitution phase is not easy. Chile underwent more than a decade of crisis, during which its economy tended to stagnate, and the political life of the country was marked by a high degree (for Chile) of instability. Brazil has been experiencing a very similar crisis since the exhaustion of import-substitution possibilities with the end of the Juscelino Kubitschek administration in 1961. Even Mexico has found it difficult to switch to the emphasis on investment in agriculture which its situation has required.

However, it is noteworthy that certain of the requirements of the third phase of development which we have discussed are being increasingly recognized in these countries. Schools of business, designed to train professional managers, are appearing in increasing numbers. Unaccustomed attention is being given to the training of manual workers in the skills required by the new industrial society. Industrialists in some of the countries have shown a new interest in an agrarian reform, either supporting it or at least remaining neutral on the subject. The governments are increasingly turning their attention to the capital needs as well as to the requirements for reform of the agricultural sector.

We would not suggest that the strategy or model of import-substitution industrialization which we have outlined in this article is applicable in every

detail to all of the countries which in general are following it. In Mexico, for instance, agrarian reform preceded the main spurt of import-substitution industrialization, while in Venezuela the two things have been occurring simultaneously. In some cases, undoubtedly, frequent contacts with United States businessmen have developed an interest in more scientific organization of individual enterprises considerably before the conditions of the national market would have engendered such interest. Other divergences from the pattern undoubtedly could be found in particular countries.

However, we hope that the conceptual framework of import-substitution industrialization makes somewhat clearer the process which is under way in many of the developing countries today. We think that it gives at least the hint of answers to a number of problems which otherwise are hard to explain.